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SUBJECT: Slow Progress in a Tough Neighborhood: Economic and Political Change in South China over Four Years

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11. (SBU) Summary and Comment: This cable by Guangzhou's departing Economic/Political Section Chief is a brief look at south China after four years, how it has developed economically, the pluses and minuses, challenges and potential, where it's going in the future. The Pluses: South China and particularly the Pearl River Delta (PRD), the world's factory floor, have succeeded economically beyond any Communist apparatchik's wildest dreams. The economy is accelerating even more rapidly due to China's WTO accession and is expanding vertically and horizontally. A middle class and a domestic market are taking shape. A well-developed transportation network links province to province and city to city, enabling inter-provincial commerce to blossom and manufacturing to slowly move inland. The Pan-PRD and the Closer Economic Partnership Agreement (CEPA) initiatives have expanded cooperation between a number of Chinese provinces and Hong Kong and Macau.

12. (SBU) The Minuses: Such rapid expansion has come with environmental and social costs. Energy is at a premium, air quality has deteriorated, water is in short supply; these are all serious constraints. Corruption is rampant despite government efforts to crack down. Income gaps between rich and poor, urban and rural, and coastal and inland, continue to exist with little-to-no improvement in sight. And there has been little movement on local political reform.

13. (SBU) COMMENT: The income gap, while important, does not seem as important as the opportunities available to advance oneself economically. When those opportunities decline because of corruption, arrogance, pollution, or poor management, the average person will react and demonstrations - of which there are likely far more than reported in the press or of which we hear about from word-of-mouth - follow. The Party and the government still have difficulty accommodating dissent and generally crack down on or whitewash incidents. Civil unrest remains largely at, and is dealt

with by, the local level and does not threaten Party control. In the absence of major social upheaval or revolution, neither of which appears likely, any reforms would appear to occur first in the Party and gradually move out to society. The hope, as always, is that as society changes, the Party and government will change too. Looking down the road, barring major outside shocks, such as war, depression or global pandemic, south China's robust economic growth should continue. End Summary and Comment.

What Has Changed: Rapid Economic Growth in all Directions

¶4. (SBU) South China's economy has expanded rapidly in size, as well as vertically, with rising levels of technology, and horizontally, by expanding inland and gradually abroad (ref C). Due to the crowding out of land and insufficient labor, water, and power in the PRD, governments at all levels in Guangdong are focusing their efforts to attract FDI on capital intensive, small footprint, high technology firms. Labor-intensive investment and low-value-added firms are no longer welcome in the Pearl River Delta area of some 30 million-plus people and there has been a conscious effort to move them out. They are free to go inland to Guangdong's second and third tier cities or into Guangxi and Fujian's less developed areas.

¶5. (SBU) What has made this possible is the horizontal growth of the economy, through the rapid construction of an interstate toll road system and a provincial road network in each of the provinces in south China. This development is mirrored, at least to some extent, in the rest of China (refs A, F, and G). What used to take 7-12 hours to cross now takes only 3-4 hours as bridges span rivers and tunnels cut through difficult mountain terrain. Air and sea ports, rail lines, and inland waterways are also being upgraded and expanded. Many of the larger labor-intensive factories are not yet

GUANGZHOU 00000786 002 OF 004

moving out of the PRD, however, when they expand their operations, they generally find themselves looking elsewhere. Less risk-averse investors are opening new factories and offices in western Guangdong, in Guangxi, and further north and west. On the regional level, a healthy competition between the PRD and the Yangtze River Delta (YRD) exists, and Hong Kong and Macau continue to integrate economically with South China.

¶6. (SBU) In the past few years, the central government has given its blessing to state-owned enterprises and private firms to invest abroad, with Guangdong-based firms often taking the lead (ref D). This stronger China is beginning its outward march for resources and markets, gradually flexing soft power muscles in Asia and Africa, but not necessarily in the United States. The consulate has recently emphasized our new "Invest America" plan, but we've attracted few questions about what the benefits of doing so will be.

WTO - A Major Factor in Economic/Legal Changes

¶7. (SBU) While not the only factor, China's entry into the WTO and subsequent five-year transition period (which ended in December 2006) brought dramatic growth in foreign trade and was a major factor in changes in China's commercial and legal framework. Numerous barriers to market opening remain; new non-tariff barriers have been thrown up as tariffs have fallen, such as local standards and sanitary and phyto-sanitary issues.

¶8. (SBU) WTO-led transparency, while slow at first, is expanding in the legal field with the government seeking public comments on draft laws and regulations. At times, foreign businesses have been asked for their opinions. In fact, the local Amcham was criticized for appearing to try to protect certain practices that would seem beneficial to them, but not to the average worker, in the new labor law. While limited in scope, the trend is toward greater transparency. People in south China, especially the PRD and more economically advanced areas have become more aware that they have a voice in government that deserves to be heard, a development with

long-term potential for influencing government decisions. There appears also to be greater awareness of environmental, political, and economic matters, even the outside world, despite censorship and clamps on media. Today, moreover, with the environmental focus in the 11th Five-Year Plan (2006-2010), officials are supposed to be evaluated not only on their economic performance, but also on how "green" that performance is.

Development of a Middle Class and a Domestic Market

¶9. (SBU) At the same time, rapid growth has caused average incomes to rise, leading to the creation of a new class recently identified by the China Academy of Social Sciences (without calling it a middle class). Three years ago, we could not get meetings to discuss the emergence of a middle class. This concept is still somewhat divisive, as a "middle class" cuts through the middle of society and conflicts with the Chinese concepts of a "xiao kang she hui" ("moderately well-off society" - a unitary whole) and the development of Hu Jintao's idea of a "Harmonious Society." In Guangzhou and Shenzhen, as well as many secondary and even tertiary cities in south China, this already moderately wealthy society (by Chinese standards) has begun to consume products, have leisure time, and avail itself of travel, both internal and international. New malls are sprouting up like wildfire; Guangzhou reportedly has Asia's largest shopping center - Grand View Mall. Middle class Chinese have something they own and something to protect and it will be an unwise government that seeks to roll that back, even in the interest of spreading the benefits of wealth around. Chinese in general have high rates of cell phone and internet use.

¶10. (SBU) Since everything is manufactured here, Chinese have access to the latest technology. South China two years ago surpassed Hong Kong as the world's largest purchaser of high-end luxury vehicles. The housing market is booming and there are plenty of buyers. The travel market is expanding rapidly and increasingly large numbers of Chinese are traveling abroad. The number of sporting activities has grown and will continue to generate interest in the run-up to the Beijing Olympics, as well as Shanghai's and Guangdong's major sporting events in 2010 (the Asia Games will be in Guangzhou in 2010). All of this activity offers opportunities to U.S. manufacturers, service providers, and the sports and entertainment

GUANGZHOU 00000786 003 OF 004

industries.

¶11. (SBU) The growth of a robust domestic market will help to even out some of China's economic inequities, spread the wealth, and encourage the development of inland industries more oriented to the domestic market. The Pan-PRD and the Closer Economic Partnership Agreement (CEPA) programs have expanded cooperation among a number of Chinese provinces and Hong Kong and Macau. Still, with the bulk of the population living closer to the coast, the majority of industrial development is likely to stay in that area.

What has Not Changed: The Dark Side -
Costs of Economic Growth

¶12. (SBU) South China's rapid expansion has come with environmental and social costs that are mirrored across China. Economic growth without regard to environmental considerations has fouled the water, soil, and air and raised social costs, a fact only recently acknowledged and occasionally acted upon by the central government. Electric power is in short supply; despite robust construction it is hard to keep up with the dramatic growth in demand (ref B) and power outages and rolling black/brownouts are not infrequent in some areas. Companies increasingly resort to small, inefficient, and highly polluting power generators to maintain their manufacturing schedules. Electric power shortages can be resolved with new construction and energy inputs; however, water is a different issue. The water is not only highly polluted, but the shortage of potable water in many areas and of water for agricultural and industrial uses will continue to act as a serious constraint (ref P). Labor shortages and abuses are regularly reported (refs M and J). Counterfeiting and piracy are rife, while government crackdowns,

though numerous, are ineffective. At the same time, the government is focused on building its own intellectual property rights (IPR) and national brands (not a bad thing), but is also using IPR "abuse" as a tool to extract business secrets from multinational corporations.

¶13. (SBU) Official corruption continues to be rampant despite government efforts to crack down, weakening the legitimacy of the Party. Politically, the government still responds to embarrassing disclosures using tit-for-tat tactics, e.g. attacking local American company labor practices or the safety of U.S. agricultural imports to demonstrate that the problem is not China's alone (ref J) and sometimes even giving the Chinese companies a free pass as the foreign companies are taken to task.

The Poor and Civil Unrest

¶14. (SBU) The poor are still impoverished, despite recent attempts to build a "new countryside" and they have seen little improvement in their lives to date. Income gaps between rich and poor, urban and rural, and coastal and inland continue to exist with little to no improvement in sight. Rapid urbanization and industrialization, often tainted by corruption, create stresses, particularly regarding land acquisition. The urban-rural income gap remains at a 3:1 ratio virtually regardless of location. The gap, while often cited as a key element in civil unrest, does not seem as important as a person's opportunities to move up the economic ladder. When those opportunities are closed off because of corruption, arrogance, pollution, or poor management, the average person will react, leading to numerous incidents of mass demonstrations, some which end in violence. Much of our reporting has been on the conflicts and trade-offs among economic gain, wild West-type development, corrupt practices, and official connivance in business chicanery: environmental protests (Xiamen public against a chemical factory - ref E); land acquisition and inadequate compensation (Dongzhou's violent protests - refs L, K, and O); and out and out corruption (Taishi and Gurao - ref H). All of these incidents have remained localized, there is no pattern connecting them, and the Party remains comfortably in control at present. In the absence of major social upheaval or revolution, neither of which appears likely, any reforms will have to occur in the Party first and only gradually move out to society.

The Party Comes First

¶15. (SBU) Through all of this growth, the Communist party has tried to keep up with the changes and professionalize its cadre by adding

GUANGZHOU 00000786 004 OF 004

business administration and management courses to the Party School syllabus (ref Q). Some of the newer cadre are sophisticated and can see change in its multiple dimensions, unlike the more ideologically-driven old guard. Despite continued party control, the government in many ways has show an impressive ability to adapt to rapid changes. It has been slow to react to some issues, such as labor rights, but is anticipating others, such as the aging population and the need for a better social security system and even a health system. On the political side, things do not appear to have improved much. There is talk of democratizing within the Party but there remains little democracy for the masses, grassroots experiments aside. Apart from exceptions for Olympic press coverage, media controls and censorship remain strong, and have strengthened under the Hu/Wen regime. There is little tolerance for dissent in south China; it's clear that this is a politically backward area, focusing on economic advancement at the cost of advancing new ideas that could provide significant alternatives to the way things are done, including business ideas (ref N). Official rhetoric emphasizes nationalism and territorial integrity, though where Taiwan fits into the overall equation is exceedingly complex, given ties of affinity and, in some locations, dependence for economic gain.

Comment: Continued Growth but Questions Remain

¶16. (SBU) In the long run, the south China economic machine should continue to gallop along at approximately 10-12 percent annual growth. A stronger domestic market should help cushion south China manufacturing from an outside shock, though with the current heavy reliance on exporting, a severe shock would greatly affect business and labor here. Despite structural weaknesses of uneven development and income inequities, there does not appear to be a reason, barring a U.S. or global depression, major war, or pandemic outbreak (that could easily originate in south China) that would stop this growth. But with the expectation of a better standard of living about all that the Party has to offer, serious social problems could occur if that hope disappears.

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